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**GETTING GOING**

By JONATHAN CLEMENTS



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## Forget the Backlash: Index Funds Still Make Sense for Most Investors

Here's a startling revelation: Index funds have fallen just as much as the stock-market averages.

Are you shocked? Wall Street's talking heads certainly are. This is, we are told, yet further proof that index funds are a rotten investment.

"Forget buy and hold," the pundits cry. "Index funds are guaranteed mediocrity," they claim. "Now, we're in a stock picker's market."

Give me a break.

This outbreak of anti-indexing fervor shouldn't be any great surprise. Most of Wall Street loathes index funds. The Street makes a lot more money when investors ignore index funds and instead treat investing as a high-stakes horse race, trading feverishly and favoring active money managers.

For those who want to bash indexing, this looks like the ripest of opportunities. From the market peak in March 2000 through June 2002, U.S. stock funds lost a cumulative 26.4%, on average, far less than the 32.1% decline by Vanguard Group's giant \$70 billion Standard & Poor's 500-stock index fund.

Tempted to give up on indexing? Take a moment to ponder three key questions.

### Are index funds "guaranteed mediocrity"?

The pundits' huffing and puffing can't change the basic math of investing. Before costs, investors collectively match the results of the market average. After costs, investors -- as a group -- will lag behind.

#### PERFORMANCE GAP

This is where index funds get their edge. They

#### ABOUT THE AUTHOR

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Jonathan is the author of "25 Myths You've Got to Avoid -- If You Want to Manage Your Money Right" and "Funding Your Future: The Only Guide to Mutual Funds You'll Ever Need." He has won a number of journalism awards, including the 1996 "Articles of Excellence" award from the Certified Financial Planner Board of Standards and the American University/ICI Education Foundation's 1992 award for personal-finance writing. He has two children and lives in Metuchen, N.J.

simply buy the stocks that make up a market index, in an effort to replicate the index's results, while incurring relatively modest costs.

That might seem like a recipe for mediocrity. But, in fact, it turns out to be a winning strategy. Because other investors are racking up much higher costs, they are destined to do even worse, on average.

### **Do actively managed funds fare better?**

Even though index funds are sure to outperform most active investors, that doesn't mean they will necessarily outperform most actively managed funds. Maybe fund managers are smarter than other active investors.

On that score, fans of actively managed funds occasionally get a glimmer of hope. This is one of those times. In this year's first six months, Vanguard's S&P 500 fund has lagged behind 54% of U.S. stock funds.

But before we proclaim the triumph of active management, take a moment to consider the comparison. The S&P 500 is a large-company index, while actively managed stock funds tend to own somewhat smaller stocks and typically keep around 5% of their portfolios in cash.

Now, think about what has happened this year. Small stocks have outperformed bigger companies and holding cash has bolstered results, because share prices have fallen. Under those circumstances, the relative performance of Vanguard's S&P 500 fund seems remarkably good.

There have been plenty of other years when S&P 500 funds have looked like a punk investment. But as you stretch the time horizon, indexing's cost advantage shines through. Vanguard's S&P 500 fund has beaten 50% of U.S. stock funds over the past five years, 64% over the past 10 years, 67% over 15 years and 81% over 20 years, according to calculations by Vanguard using Lipper data.

Even in the short run, indexing doesn't look nearly so foolish if you make a cleaner comparison. Instead of comparing funds to the S&P 500, I asked Chicago fund researchers Morningstar Inc. to look at its nine style boxes. The nine boxes are based on the size of companies bought (small, medium or large) and on stock-picking style (growth, value or some blend of those two styles).

For all nine style boxes, actively managed funds were compared to an appropriate S&P index. For instance, small-company growth funds were stacked up against the S&P SmallCap 600/Barra Growth Index, mid-cap blend funds were compared to the S&P MidCap 400 Index, and so on. Result? In seven of the nine style boxes, the

majority of actively managed funds have lagged behind their index since the March 2000 market peak.

### **Can you pick the winners?**

Even fans of actively managed funds often concede that most other investors would be better off in index funds. But buoyed by abundant self-confidence, these folks aren't about to give up on actively managed funds themselves.

A tad delusional? I think so. Picking the best-performing funds is "like trying to predict the dice before you roll them down the craps table," says Art Canter, an investment adviser in Boca Raton, Fla. "I can't do it. The public can't do it."

Still, I figure we shouldn't discourage fans of actively managed funds. With all their buying and selling, active investors ensure the market is reasonably efficient. That makes it possible for the rest of us to do the sensible thing, which is to index.

Want to join me in this parasitic behavior? Despite all the focus on S&P 500 funds, I would favor funds that mimic the broader Wilshire 5000. To build a well-diversified portfolio, you might stash 70% of your stock portfolio in a Wilshire 5000-index fund and the remaining 30% in an international-index fund.

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